

GENERAL INFORMATION

The Community Reinvestment Act (“CRA”) requires each federal financial supervisory agency to use its authority when examining financial institutions subject to its supervision to assess the institution’s record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of the institution. Upon conclusion of such examination, the agency must prepare a written evaluation of the institution’s record of meeting the credit needs of its community.

This document is an evaluation of the CRA performance of Wadena State Bank, Wadena, Minnesota, prepared by the Federal Reserve Bank of Minneapolis, the institution’s supervisory agency, as of June 2, 1997. The agency rates the CRA performance of an institution consistent with the provisions set forth in Appendix A to 12 CFR Part 228.

INSTITUTION’S CRA RATING: This institution is rated “Outstanding.”

The bank’s CRA rating is based on several factors. First, the bank’s loan-to-deposit ratio has remained satisfactory since the previous evaluation and is augmented by sale of loans and participation in community development lending activities. Second, the bank has originated a significant majority of its loans in the assessment area. Third, the bank’s lending distribution pattern to borrowers of different income levels and businesses of different sizes is reasonable. In addition, the bank has a reasonable distribution of loans among geographies of different income levels. Finally, the bank made a substantial investment in a qualified community development project since the prior evaluation.

DESCRIPTION OF INSTITUTION

Based on its size and financial condition, the bank is able to effectively meet the credit needs of its assessment area. The bank was rated satisfactory in helping to meet the credit needs of its assessment area at its previous CRA evaluation. The bank's only office is located in Wadena, Minnesota, and its automated teller machine ("ATM") is in the entryway of the bank.

The bank's total assets have grown approximately 9% since the previous evaluation, from \$50.7 million to \$55.3 million as of the March 31, 1997, Report of Condition ("ROC"). Net loans have increased from \$26 million to \$27.4 million over the same time period. Bank management attributed the growth to ongoing community and credit ascertainment activities, and the multitude of loan programs that the bank provides. Total deposits have increased from \$44.1 million to \$48.4 million since the previous evaluation. The bank attributed the growth in deposits to normal operations. The composition of the bank's loan portfolio is 41% commercial, 33% consumer real estate, 14% agricultural, and 12% consumer loans.

The bank offers a wide variety of loan programs for consumers, farmers, and small businesses in its assessment area. Its residential real estate programs include conventional, Federal Housing Administration ("FHA"), Department of Veterans Affairs, Minnesota Housing Finance Agency ("MHFA") First-Time Home Buyers, MHFA Home Improvement, MHFA Home Energy, and FHA Title I home improvement mortgage loans. In addition, the bank successfully obtained grant money from the Federal Home Loan Bank of Des Moines. These funds were used to assist first-time homebuyers with down payment or closing cost funds.

The bank also offers a wide variety of commercial and agricultural loan programs. The commercial loan programs are directed primarily toward small business and include Small Business Administration ("SBA"), Capital Access, and Business Manager loans. Small business customers may obtain equipment, working capital, accounts receivable, and commercial real estate loans through one of these programs or directly from the bank. The bank offers agricultural borrowers Rural Finance Authority and Farm Service Agency ("FSA") guaranteed loans. Also, it provides direct agricultural operating, machinery, livestock, and real estate loans.

DESCRIPTION OF WADENA STATE BANK'S ASSESSMENT AREA

The bank's assessment area consists of 10 block numbering areas ("BNA") that lie in Todd, Otter Tail, and Wadena counties. The assessment area includes a large number of small towns. Wadena County consists of BNAs 9801, 9802.98, 9803, and 9804.98. The 1990 U.S. Census data indicate the population and number of households in BNA 9804.98 are zero. Bank management did not know what this BNA encompassed. The bank and its ATM are located in BNA 9803. BNA 9803 is centrally located among the BNAs that comprise the assessment area. In fact, BNA 9803 borders Otter Tail County and northeastern Todd County. BNAs 9605, 9606, 9613, and 9614 are in Otter Tail County and make up the western portion of the bank's assessment area. The southern portion of the bank's assessment area includes BNAs 9902 and 9903, which lie within Todd County.

Individuals familiar with residential, small business, and agricultural development issues in the assessment area were interviewed during the CRA evaluation. Information from these contacts and bank management was used in the evaluation of the bank's CRA performance. Community contacts indicated that Wadena's population has remained relatively stable since the 1990 U.S. Census. A 1994 estimate provided by one of

the community contacts had Wadena's population as 4,240, compared with the 1990 census figure of 4,242. Although there are a few vacant commercial buildings in Wadena, contacts indicated the local business economy is stable. Community contacts provided an economic profile of Wadena and Wadena County. The profile listed the major employers as a furniture manufacturer with 364 employees, a hospital with 227 employees, the local public schools with 215 employees, and the local county government offices with 165 employees.

Economic information provided by agricultural contacts indicates farming represents the largest industry in the area. Dairy farming is the primary sector, but beef, pork, turkey, corn, potatoes, soybeans, and forage crops are also produced. Data provided by the contact indicated the number of dairy farms in Wadena County has decreased from 192 in 1991 to approximately 150 in 1995. The agricultural contact attributes the decline to the loss of family farms. A sizable number of dairy farms are family operations. However, younger family members are not taking over the dairy operations when their parents retire. Although the number of dairy farms has been declining, milk production levels have remained fairly constant from 1991 to 1995. A problem for dairy farmers has been forage and hay crop prices. The cost to purchase these crops, which are used to feed dairy cattle, has become very high. As a result, a number of dairy farmers have purchased local farms and started growing their own forage crops to feed their herds.

A community contact provided housing and commercial real estate activity information for Wadena. In 1996, seven new residential and four new commercial buildings were constructed. According to 1990 census data, the median housing value in the assessment area was \$36,923. Approximately 40% of the housing in the assessment area is over 40 years old. In addition, community contacts stated that Wadena has a large senior citizen population. Demographic information for Wadena County based on 1990 census data indicates that 19% of the county's population was age 65 and over. Approximately 29% of the county's population was over the age of 55, 43% was between 18 and 54 years old, and the remaining 28% was under 17 years old.

As previously mentioned, the bank's assessment area consists of 10 BNAs. Based on the 1990 U.S. Census data, BNAs 9613, 9902, 9903, 9801, and 9802.98 are classified as moderate income. The population in these moderate-income BNAs is 17,296, or 54% of the total assessment area population. BNAs 9605, 9606, 9614, and 9803 are classified as middle income. These BNAs have a total population of 14,616, or 46% of the total population. The bank's office and ATM are located in BNA 9803. None of the BNAs in the bank's assessment area are classified as upper income. The assessment area's one low-income BNA (9804.98) has no population.

CRA divides income levels into four categories: low, moderate, middle, and upper. Because the bank's assessment area is not located in a metropolitan statistical area ("MSA"), the categorization of a borrower or geography's income is determined relative to the statewide nonmetropolitan median family income. Low-income individuals have incomes of less than 50% of the statewide nonmetropolitan median family income, while moderate-income individuals have incomes of at least 50% but less than 80% of this amount. The regulation defines a middle-income individual as one with an income of at least 80% but less than 120% of the statewide nonmetropolitan median family income. An individual with an income that is 120% or more of the statewide nonmetropolitan median family income is considered upper income. BNAs are classified using similar categories based on the level of the median family income in the geography.

Minnesota's nonmetropolitan median family income of \$28,933, as of the 1990 U.S. Census, is used to classify the income level of the assessment area's BNAs. The 1997 median family income for Minnesota's nonmetropolitan areas is \$38,400. This figure is used to classify the income level of individual borrowers.

According to 1990 U.S. Census data, the assessment area's median family income is \$22,903, and the median household income is \$18,093. The census data provides a breakdown of the percentage of low-, moderate-, middle-, and upper-income individuals who reside in the assessment area. According to the census data, 34% of the households in the assessment area are classified as low income, 18% as moderate income, 19% as middle income, and 29% as upper income. The number of households in the assessment area with incomes below the poverty level is 23%. The number of families in the assessment area with incomes below the poverty level is 17%.

CONCLUSIONS WITH RESPECT TO PERFORMANCE CRITERIA

The bank has done a satisfactory job of meeting the credit needs of its assessment area. Much of the analysis on the following pages was based on a statistical sample of 119 consumer and 88 commercial and agricultural loans originated in the six months before the evaluation. The analysis of the bank's consumer real estate lending is based on a sample of 70 loans originated in the 12 months preceding the evaluation. More weight was given to the borrower and geographic distribution categories in determining the bank's CRA rating. These categories focus on the bank's commitment to serving the credit needs of all segments of its assessment area, including low- and moderate-income borrowers and geographies. The following criteria were reviewed in determining this rating.

LOAN-TO-DEPOSIT RATIO ANALYSIS

The bank's loan-to-deposit ratio exceeds the standards for satisfactory performance. The bank's quarterly average loan-to-deposit ratio since the previous evaluation is 56%. The bank's ratio has fluctuated from 52% to 59% since the previous evaluation. The following table, based on quarterly ROC data, reflects this pattern.

Date	Net Loans (In thousands)	Deposits (In thousands)	Net Loan-to- Deposit Ratio
March 31, 1997	\$27,490	\$48,401	57%
December 31, 1996	\$27,577	\$50,586	55%
September 30, 1996	\$25,711	\$49,870	52%
June 30, 1996	\$27,434	\$47,453	58%
March 31, 1996	\$26,042	\$44,171	59%

According to the March 31, 1997, Uniform Bank Performance Report, the bank's loan-to-deposit ratio of 57% places it in the 33rd percentile of its peer group.

Economic data provided by community contacts indicate there are three financial institutions and one credit union located in Wadena. Also, there are seven different financial institutions located in the bank's assessment area. Financial data on the competitor banks is illustrated in the following table.

Bank Name	Total Assets March 31, 1997 (In thousands)	Quarterly Average Net Loan-to- Deposit Ratio
Wadena State Bank Wadena, MN	\$55,305	56%
First National Bank in Wadena Wadena, MN	\$36,320	47%
First National Bank Henning, MN	\$46,876	60%
Security State Bank of Deer Creek Deer Creek, MN	\$14,077	41%
Farmers & Merchants State Bank of New York Mills, Inc. New York Mills, MN	\$44,373	54%
United Community Bank Perham, MN	\$87,131	77%
First National Bank Menahga, MN	\$33,682	60%
Security State Bank of Sebeka Sebeka, MN	\$19,334	61%
First National Bank of Bertha-Verndale Bertha, MN	\$38,288	65%

The bank's loan-to-deposit ratio is in the middle of the range for its competitor banks, but is significantly higher than that of the competitor bank located in Wadena. The Perham, Minnesota, bank has a ratio quite higher than the other banks. However, this bank is larger than the other competitor banks and is located in the northwest corner of the assessment area, a significant distance from Wadena. Community contacts indicated that local banks will facilitate loan requests by participating portions to other local area banks. Also, individuals who reside near or in these other towns will not drive to Wadena to conduct their banking business. The contact indicated that local banks will refer their customers to competitor banks for specialized loan programs the competitor offers.

As discussed under the Description of Institution section, the bank offers a large variety of loan products that benefit the community. Community contacts identified it as one of the leading financial institutions in Wadena. The bank has originated and sold a significant amount of consumer real estate loans on the secondary market. If these sold amounts were included, the bank's loan-to-deposit ratio would increase slightly.

In addition, the bank has made the following community development loans since the last evaluation:

- In April and December 1996, the bank originated two commercial loans through the Capital Access program. This program helps provide loans to small businesses.

- In March 1997, the bank originated a commercial loan to a local affordable housing organization. The loan provided gap financing that helped the organization complete the home under construction.
- In June 1997, the bank originated a commercial loan for the construction of an apartment building for moderate-income individuals. This project also occurred in a moderate-income BNA.
- The bank originated several SBA loans over the last 12 months.

Based on the bank originating a sizable number of loans and then selling them on the secondary market, community contacts identifying the bank as a financial leader in Wadena, and the bank's number of community development loans, the bank's loan-to-deposit ratio exceeds the standards for satisfactory performance.

COMPARISON OF CREDIT EXTENDED INSIDE AND OUTSIDE THE ASSESSMENT AREA

The bank's lending activity within its assessment area exceeds the standards for satisfactory performance. The significant majority of loans sampled were originated inside the bank's assessment area. The following table illustrates the types of loans sampled and indicates the percentage of loans and amounts originated within the assessment area.

PERCENTAGE OF LOANS IN THE ASSESSMENT AREA		
Loan Type	Total Number of Loans	Total Amount of Loans
Consumer	89	89
Consumer Real Estate	94	92
Commercial and Agriculture	92	96

The data in the table was based on a 6- to 12-month statistical sample of the bank's lending activity. As indicated in the table, the bank originated the significant majority of its loans within its assessment area. As such, the bank's level of loans in its assessment area exceeds the standards for satisfactory performance in this category.

LENDING TO BORROWERS OF DIFFERENT INCOME LEVELS AND TO BUSINESSES OF DIFFERENT SIZES

The bank's lending to borrowers of different income levels is reasonable and meets the standards for satisfactory performance. As previously mentioned, CRA classifies income levels into four categories: low, moderate, middle, and upper. Because the assessment area is not located in an MSA, a borrower's income level is determined in relation to the statewide nonmetropolitan median family income for Minnesota. Based on 1990 U.S. Census data, the median household income for the bank's assessment area is \$18,093. The assessment area's median family income is \$22,903. The assessment area's median family income is about 79% of the 1990 nonmetropolitan Minnesota statewide average.

Income information was obtained from consumer and consumer real estate loans selected for the review. Approximately 42% of the consumer and 26% of the consumer real estate assessment area loans sampled did not contain income information. The rating for this category was based on the income information obtained from the remaining files. Since the previous evaluation, the bank focused its efforts on obtaining updated applications and financial statements from borrowers. The following table reflects the distribution of consumer and consumer real estate loans, based on income level, originated by the bank during the sample period.

DISTRIBUTION OF LOANS BY INCOME LEVEL IN THE ASSESSMENT AREA*				
Loan Type	Low Income	Moderate Income	Middle Income	Upper Income
<i>Consumer</i>				
Total Number of Loans	44%	33%	11%	11%
Total Amount of Loans	27%	22%	29%	22%
<i>Consumer Real Estate</i>				
Total Number of Loans	10%	14%	41%	35%
Total Amount of Loans	5%	17%	39%	39%
*Income level is determined based on Minnesota's 1997 statewide median family income of \$38,400.				

The income data collected from the consumer files indicate the bank originated 77% of its consumer and 24% of its consumer real estate loans to low- and moderate-income borrowers. As previously discussed, 52% of the assessment area's households are classified as low and moderate income. As previously noted, consumer loans represent 12% of the bank's loan portfolio. Accordingly, although the bank's consumer lending appears focused on low- and moderate-income individuals, the absence of income information for a significant percentage of borrowers and the relatively small representation of consumer loans in the portfolio reduces the weight placed on this distribution in assigning the rating.

The file sample reveals that the percentage of the bank's consumer lending to low- and moderate-income individuals exceeds the percentage of low- and moderate-income households in the assessment area. However, the bank's consumer real estate lending to low- and moderate-income individuals is less than the percentage of low- and moderate-income households in the assessment area. The bank attributes this trend to several factors. First, the bank follows secondary-market mortgage underwriting guidelines for consumer real estate loans. The underwriting guidelines set by the secondary market are conservative and have specific parameters that must be followed. The bank does not have to comply with these parameters, but to maintain its flexibility and minimize liquidity concerns, the bank follows these guidelines to sell these loans to the secondary market. The bank does offer various governmental housing programs directed to low- and moderate-income individuals. Finally, conversations with the bank and community contacts, plus economic data, imply there is not an abundance of affordable housing in the assessment area. In 1996, seven new homes were built, each exceeding \$100,000 in assessed value. In addition, contacts indicated a sizable portion of Wadena's population are senior citizens. Such individuals rarely have demand for residential real estate loans. However, the bank participated in helping to provide assisted-living apartment complexes for senior citizens.

The bank has a strong record of lending to small businesses in its assessment area. Based on the commercial and agricultural loans sampled, 96% went to businesses and farms with less than \$1 million in gross annual revenues. The distribution pattern from the commercial and agricultural loan file sample indicates that 96% of the loan amounts were equal to or less than \$100,000, 3% were over \$100,000 but less than \$250,000, and 1% were over \$250,000 but less than \$1 million. Commercial loans represent the largest portion of the bank's loan portfolio. The percentage of commercial and agricultural loans to small businesses and farms is consistent with the bank's asset size and legal lending limit, the characteristics of its assessment area, and the economic conditions in its assessment area.

The bank is an active lender of MHFA home improvement, home energy, and conventional purchase loans. The bank also made several FSA-guaranteed agricultural loans since the previous evaluation.

The lack of income information for a number of consumer loans limits the weight given to consumer lending in reaching a rating. The level of consumer real estate loans provided to low- and moderate-income borrowers is down from that achieved at the prior evaluation but remains reasonable based on the lack of affordable housing and the various governmental mortgage loan programs available for low- and moderate-income households offered by the bank. Lending to small businesses and farms is strong. Accordingly, the bank's lending to individuals of different income levels and businesses of different sizes meets the standards for satisfactory performance.

GEOGRAPHIC DISTRIBUTION OF LOANS

The bank's lending distribution pattern among BNAs of different income levels is reasonable and meets the standards for satisfactory performance. As previously discussed, the bank's assessment area consists of 10 BNAs. The assessment area consists of five moderate-income BNAs and four middle-income BNAs. The assessment area also has one low-income BNA that has no residents. The 1990 census data indicate 54% of the assessment area's population reside in the moderate-income BNAs and 46% reside in the middle-income BNAs. The percentages in the following table illustrate the bank's lending distribution pattern between the moderate- and middle-income BNAs in its assessment area.

DISTRIBUTION OF LOANS BY BNA INCOME LEVEL*		
Loan Type	Moderate- Income BNAs	Middle- Income BNAs
<i>Commercial and Agricultural</i>		
Total Number of Loans	35%	65%
Total Amount of Loans	17%	83%
<i>Consumer Real Estate</i>		
Total Number of Loans	24%	76%
Total Amount of Loans	22%	78%
<i>Consumer</i>		
Total Number of Loans	22%	78%
Total Amount of Loans	25%	75%
* The assessment area does not have any upper-income BNAs. The low-income BNA is not included in this chart because it has no residents.		

The table indicates that the bank originated 35% of its commercial and agricultural, 24% of its consumer real estate, and 22% of the consumer loans in the moderate-income BNAs. The bank's lending in the moderate-income BNAs is below the percentage of the assessment area population that reside in these BNAs. There are several reasons for these low lending percentages. First, the bank indicated a primary reason for the low lending percentages is its location in the center of a middle-income BNA. The majority of the bank's borrowers live in Wadena and the surrounding rural area. As discussed, Wadena is in middle-income BNA 9803. Second, the competitor banks mentioned in the Loan-to-Deposit Ratio Analysis section are geographically closer to the moderate-income BNAs than the bank. Community contacts indicated borrowers who live in these moderate-income BNAs will conduct their banking business with financial institutions that are closer to their operations. Finally, the moderate-income BNAs are predominantly farmland. Agricultural loans represent only 14% of the bank's loan portfolio. However, the bank did make a higher percentage of its commercial and agricultural loans in the moderate-income BNAs. Although the bank originates agricultural loans, the bank originates a greater number of commercial, consumer real estate, and consumer loans because of its location in one of the assessment area's larger communities.

An analysis of the bank's lending patterns by individual BNA shows that a large percentage of sampled loans were made in BNA 9803. Most of the remaining loans are distributed fairly evenly among the other BNAs. The BNAs closest to the bank's one office have more of the lending activity. This distribution of loans appears reasonable given that the bank has only one office in the center of the assessment area, near which most of its loans are made. The bank is faced with a significant amount of competition from financial institutions in the other areas of the assessment area.

Based on the percentages of loans originated in the moderate-income BNAs and the reasons provided by bank management and confirmed by community contacts why the bank does not have more lending activity in the assessment area's moderate-income BNAs, the bank's distribution of the loans among different income geographies is reasonable. The bank's lending distribution pattern meets the standards for satisfactory performance.

INVESTMENTS AND SERVICES

In June 1996, the bank purchased a \$600,000 Wadena Housing/Redevelopment Authority revenue bond. The proceeds of the sale were used specifically for the construction of an assisted living care facility for low- and moderate-income senior citizens.

The bank donates to a number of community organizations that provide services to low- and moderate-income individuals. Recent donations include the Minnesota Habitat for Humanity and Dollars for Scholars program.

The bank engages in the following services:

- President C. J. (Kip) Browne serves as the secretary for the Tri-County Hospital Board. He also serves on the board of directors for the Wadena Development Authority ("WDA"). WDA promotes small business economic development.
- Vice President Jeffrey A. Browne serves as the secretary/treasurer on the board of directors for the Wadena Industrial Development Corporation.

- Assistant Vice President Ross Magnuson serves on the board of directors for the Wadena Housing/Redevelopment Authority. Mr. Magnuson also spoke at a first-time homebuyers seminar in April 1997.

As an alternative delivery system, the bank provides 24-hour telephone banking for its customers. Bank customers outside of Wadena have access to the system through the use of a toll-free telephone number. The bank also has an automated teller machine at its office.

The bank's service activities, while favorable, do not substantially affect the bank's rating. However, the bank's investment activity since the last evaluation is significant, especially given the Bank's size and rural location. Accordingly, the investment activity combined with the substantial community development lending activity discussed in the loan-to-deposit ratio section warrants an outstanding rating.

GENERAL

The evaluation did not reveal any practices that are inconsistent with the substantive provisions of the fair lending and fair housing laws and regulations. The evaluation revealed an isolated violation of the technical aspects of Regulation B's Equal Credit Opportunity Act. Management promised prompt corrective action. In addition, the bank has not received any CRA-related complaints since the last evaluation.

PUBLIC DISCLOSURE

June 2, 1997
Date of Evaluation

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

Wadena State Bank
Name of Depository Institution

092762600000
Identification Number of Institution

Wadena, Minnesota
Address of Institution

Federal Reserve Bank of Minneapolis
250 Marquette Avenue
Minneapolis, Minnesota 55401-2171

NOTE: This evaluation is not, nor should it be construed as, an assessment of the financial condition of this institution. The rating assigned to this institution does not represent an analysis, conclusion, or opinion of the federal financial supervisory agency concerning the safety and soundness of this financial institution.